Rate Development Methodology

Action Item

Recommendation: Approve rate development methodology and adopt resolution authorizing the Director of the Department of Technology Services to make minor adjustments to rates under specific circumstances.

Overview

The Department of Technology Services (DTS) provides centralized services for other government entities. It recovers its costs by charging customers specified rates for its services and depositing that revenue into the DTS Revolving Fund, which finances all DTS operations.

Rate setting often requires a difficult balance of objective cost analysis with the more subjective disciplines of marketing and forecasting customer demand. As the sole source of funding for the DTS, service rates are a critical component of DTS Financial Management. In addition, the methodology for rate setting must be well delineated, so stakeholders will have a clear understanding of their IT costs.

In order to establish and maintain the integrity of the DTS cost recovery function, the Technology Services Board (TSB) adopted a set of Guiding Principles for Cost Allocation and Rate Setting. These are summarized below:

- DTS strives to have reasonable rates for comparable services.
- DTS rates must be justifiable and supportable.
- DTS' internal systems should provide accurate and timely cost and activity data for rate setting and billing purposes.
- Services will be periodically reviewed to determine the most appropriate rate-setting methodology (i.e., measured usage, subscription, direct bill).
- Revenues generated from rates should fully recover the costs of the service, plus allowable reserves for working capital and equipment replacement. To facilitate the adoption of new services, this principle may be suspended for a documented policy objective and for a defined time period, after which the service is required to be compliant with the principle.
- The effort required for rate setting should be commensurate with the benefits derived.
- The rate-setting process should provide mechanisms for ongoing rate review from a financial, technical and business perspective.

General Rate Setting and Maintenance

Given the principle of aligning rates with the cost of providing service, the equation for determining rates can be summarized conceptually as follows:

$$\textbf{RATE per Billable Unit} = \frac{\textbf{Cost of Service}}{\textbf{Volume of Billable Units}}$$

This equation is the fundamental framework for all DTS rate setting. Although there are three different rate methodologies employed by the DTS and the unique characteristics of each service might require some customization of the analytical process, every step in the process can be attributed to one of the following three actions required to execute the equation:

- Define the Billable Unit
- Estimate the Cost of Service
- Estimate the Volume of Billable Units

The DTS continuously monitors the financial performance of its operations and periodically (usually annually) performs rate maintenance by adjusting rates where necessary to align service revenues with their respective costs. The presentation of the proposed adjustments is referred to as a “rate package” and historically consists of adjustments for 10-15 percent of the DTS rates. In addition to this annual process, there is sometimes a need to either change a rate or create a new rate between annual rate packages. Pursuant to the department’s enabling legislation, the Department of Finance and the TSB have a role in the review and approval of DTS rate proposals.

DTS rate packages should provide sufficient information for customers to understand the rate changes and adjust their plans accordingly, for the Department of Finance to evaluate the reasonableness of the proposed changes and impact on customer budgets, and for the TSB to understand the business and policy implications of approving the rate proposal.

Under this methodology, rate packages submitted by the DTS will include the following:

- Past Year, and estimated Current Year Revenue vs. Expense Summary by Cost Center
- Summary of rate package impact on DTS Revenue and Expenses in the Budget Year
- Listing of all proposed rate changes
- Net Customer Impact based on utilization in the current year
- Rate Change Detail (one for each service)
    - Brief summary of service
    - Summary of proposed change
    - Summary of analysis
    - Summary of business impacts

Temporary Subsidization of Services

Without temporary subsidization it would be very difficult for the DTS to successfully introduce new services. If rates were set exactly to cost, the rates for new services would be much higher for early adopters and fall over time as economies of scale produced lower costs, thus creating an incentive for customers to delay adoption until rates decreased. The effect would be to depress customer demand and prevent service growth. Recognizing this, the TSB adopted a Guiding Principle that allows for the temporary subsidization of new services.

The Guiding Principle related to temporary subsidization of new services attempts to minimize the financial risk of underutilized services by requiring that a goal and timeline be defined and managed with the caveat that failure to reach the goal would require the DTS to raise rates for those who have already transitioned to the service. In accordance with this Guiding Principle, this methodology requires that rate proposals for Temporary Subsidization include the following:

- Brief summary of service
- Statement of the policy objective for proposed subsidization
- Statement of the cost recovery objective including an explanation for the length of the transition period selected
- The customer adoption assumption including low and high scenarios and an explanation of the research conducted to support the assumption and why the assumed adoption pattern is reasonable
- The cost and revenue forecast based on the customer adoption assumption and the resulting rate at each of the four standard break-even points
- A financial risk analysis including a break-even analysis for the proposed rate and any other scenarios that are appropriate to evaluate
- The proposed rate and an explanation of why the level of subsidization and associated financial risk are acceptable to the State and the DTS

In cases when the rate proposal is for a new service, this material would be included as part of the New Service Proposal.

Governance

Rate proposals are subject to review by the Department of Finance and the TSB Services Committee, and review and approval by the TSB with recommendations from both Finance and the Services Committee. The proposed rate methodology also provides for minor adjustments to be made to rates to address immediate business needs. A minor adjustment would have minimal impact on total DTS revenue, would not significantly increase any one customer's bill, and would not represent a significant policy change or would be technical in nature. Given the nature of these adjustments, the full review and approval process for rate packages may be excessive and an abbreviated process may better suit the DTS and TSB's respective needs. However, because statute provides the TSB with rate approval authority, the delegation of authority to the Director or the State and Consumer Services Agency to make minor adjustments to rates would require a TSB resolution. The need for such a delegation is being assessed and a resolution will be brought to the Board if it is determined to be necessary.